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Family Office Insights

EU Securities Regulator Releases Final Guidelines on Investment Fund Names Using Environmental, Social and Governance (ESG) or Sustainability-related Terms

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General Overview

The first impression that an investment fund gives to prospective investors is usually its name, and this first impression can often play a role in an investor's decision to explore a potential investment further. With this in mind, and with heightened investor demand for ESG-focused funds, fund sponsors have an incentive to include sustainability-related or generic ESG terms in their names. These name choices can make it difficult for investors to verify that a fund's actual investments align with the fund's name and have increased the risk of "greenwashing," or misleading investors as to what a fund's sustainability standards truly are.

Given these risks and difficulties, the European Securities and Markets Authority (ESMA), which is the EU's principal financial markets regulator and supervisor, released its final guidelines (Guidelines) on May 14, 2024 on the use of ESG or sustainability-related terms in investment fund names – clearly interlinked with the obligation for marketing communications to be fair, clear and not misleading under the MiFID II regulations.[1]

Summary of the Guidelines

Overall, the Guidelines apply to a wide range of European investment fund managers, including managers of Undertakings for Collective Investment in Transferable Securities UCITS, EU-registered hedge funds, private equity funds, real estate investment funds and other funds that are subject to the EU Alternative Investment Fund Managers Directive.

Funds Using Transition-, Social-, and Governance-related Terms

Under the Guidelines, "Transition-, Social-, and Governance-related Terms" (i) encompass words derived from "transition" and those deriving from "improve," "progress" or similar words, (ii) give the investor any impression of the promotion of social characteristics or (iii) give the investor any impression of a focus on governance, respectively.[2] Funds cannot use these and related terms unless 80% of their investments (the "Investment Threshold") are or will be used to meet environmental or social characteristics or sustainable investment objectives.[3]

Certain types of investments within a fund's portfolio will automatically prohibit the fund from using such terms, irrespective of whether the above Investment Threshold is met. This includes investments in companies that (i) are involved in any activities related to controversial weapons, (ii) are involved in cultivation and production of tobacco and (iii) are found in violation of the United Nations Global Compact (UNGC) principles or the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises by benchmark administrators.[4]

Funds Using Environmental or Impact-related Terms

Under the Guidelines, "Environmental or Impact-Related Terms" are defined as (i) any terms that would give an investor the impression of promotion of environmental characteristics and (ii) any terms derived from the base word impact.[5] The Investment Threshold is applied to the proportion of investments used to meet environmental or impact-related objectives applies.

In addition to the excluded investments mentioned above, funds will also be wholly prohibited from using environmental or impact-related terms if their portfolio includes investments in companies that (i) derive certain percentages of their revenues from exploration, mining, extraction, distribution or refining of hard coal and lignite (1% or more), oil fuels (10% or more) or gaseous fuels (50% or more) or (ii) "derive 50 % or more of their revenues from electricity generation with a GHG intensity of more than 100 g CO2 e/kWh."[6]

Funds Using Sustainability-related Terms

Under the Guidelines, "Sustainability-related Terms" are defined as any terms derived from the base word "sustainable."[7] Both the prohibitions around portfolio composition and the Investment Threshold as identified under subsection (2) above apply. Funds using these terms should also commit to "invest meaningfully in sustainable investments."[8] It remains to be seen what "meaningfully" would be deemed to mean in this context.

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1 *Final Report – Guidelines on funds' names using ESG or sustainability-related terms,* ESMA (May 14, 2024), https://www.esma.europa.eu/sites/default/files/2024-05/ESMA34-472-440_Final_Report_Guidelines_on_funds_names.pdf ("Guidelines"); *Article 24 General Principles and Information to Clients,* ESMA, https://www.esma.europa.eu/publications-and-data/interactive-single-rulebook/mifid-ii/article-24-general-principles-and#:~:text=All%20information%2C%20including%20marketing%20communications,be%20clearly%20identifiable%20as%20such (last visited June 11, 2024).

2 Guidelines, *supra* note 1.

3 Guidelines, *supra* note 1.

4 *See* OJ L 406, 7.17.2020 ("CDR (EU) 2020/1818").

5 Guidelines, *supra* note 1.

6 CDR (EU) 2020/1818.

7 Guidelines, *supra* note 1.

8 *See* OJ L 317, 11.27.2019, p. 8 ("Regulation (EU) 2019/2088") ("'[S]ustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.").

Timeline and Reporting Requirements

Official Application Date and Initial Notice

The Guidelines will officially begin to apply three months after they are translated into all EU languages and published on ESMA's website (the "Application Date"). Two months following publication in all EU official languages, competent authorities, i.e., the national financial regulatory authorities in the EU, must notify ESMA whether they (1) comply, (2) do not comply, but intend to comply or (3) do not comply nor intend to comply with the Guidelines. Although the Guidelines stipulate that a "competent authority . . . must make every effort to comply with these guidelines," compliance is not mandatory and the national regulatory authorities can decide whether to apply such guidelines going forward or not.[9] This issue is key to enforcement of the Guidelines – ESMA itself has no authority to enforce against market participants, it is a matter for the national regulatory authorities when policing fundraising activity in their respective jurisdictions. On the other hand, ESMA has acknowledged that certain national authorities have already introduced similar measures in their own jurisdictions and that these are in some cases stricter than the Guidelines.[10]

Transition Periods and New Fund Deadlines under the Guidelines

Funds that exist prior to the Application Date will have six months after the Application Date to comply with these Guidelines, while any new funds created after the Application Date will be required to apply the Guidelines immediately.[11]

Circumstances Warranting Further Investigation or Supervisory Dialogue

Fund managers should take note that they may be subject to further investigation and supervisory action if a fund fails to meet expectations under the Guidelines. Relevant circumstances that may warrant investigation or further supervisory action include: (i) excluding temporary breaches, failure to meet the applicable qualitative threshold, (ii) failure to demonstrate the levels of investment required for use of the specific terms in the fund's name; or (iii) use of terms that will result in "investors receiving unfair or unclear information or in a failure of the manager to act honestly or fairly thus misleading investors."[12]

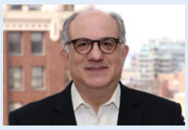
Related Points

The EU's Guidelines are not the first of its kind. In September of last year, the US Securities and Exchange Commission, through an amendment to its rule covering fund names, applied a similar 80% threshold to ensure that its "names rule" appropriately addressed ESG matters.[13] Similarly, effective May of this year, the UK Financial Conduct Authority passed an anti-greenwashing rule which included additional scrutiny with respect to "how firms use terms such as "ESG," "Green" and "sustainable" in marketing to ensure any such claims are fair, clear and not misleading."[14]

Looking forward, ESMA has noted that, in due course, it will consider additional situations outside of sustainability, and we would expect that global securities regulators will continue to be focused on the manner in which investment vehicles are named and how they are marketed.[15]

We expect that ESG-related marketing and compliance issues will continue to be a focus of EU, US and UK securities regulators, as investors seek to align their investment portfolios with their ESG philosophies. Our Family Office team will be monitoring the rulemaking in this space for further developments.

Contacts



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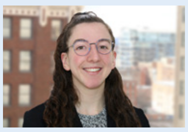

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9 Guidelines, *supra* note 1.

10 *Id.*

11 *Id.*

12 *Id.*

13 *See SEC Adopts Rule Enhancements to Prevent Misleading or Deceptive Investment Fund Names*, U.S. Securities and Exchange Commission (Sept. 20, 2023), https://www.sec.gov/news/press-release/2023-188#:~:text=The%20Names%20Rule%20currently%20requires%20registered%20investment%20companies,in%20those%20investments%20%28an%20%E2%80%9C80%20percent%20investment%20policy%E2%80%9D%29.

14 Kyle Brassuer, *ESMA guidelines tackle greenwashing via fund names*, Compliance Week (May 17, 2024), https://www.complianceweek.com/regulatory-policy/esma-guidelines-tackle-greenwashing-via-fund-names/34846.article.

15 Guidelines, *supra* note 1.

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